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ABSTRACT

Economic policies of the industrial nations are on a dangerous course, constituting a threat to worldwide growth and to financial and economic stability. The results of inappropriate policies throughout the industrial countries are (1) financial strains which endanger global economic stability, (2) extraordinary imbalances of trade, and (3) persistent budget imbalances. Two major effects of imbalances in currencies are the loss of U.S. jobs at an accelerating rate due to declines in the U.S. manufacturing sector and inflation. Although the rise in the dollar has helped reduce inflation in the United States, the current vulnerability of the dollar to a major correction creates serious concern about the course of inflation during the next few years. A final implication of misaligned exchange values involves interest rates. Even though the inflow of foreign capital has reduced interest rates in the United States, when foreign capital flows out in response to concern about weakening of the dollar, volatile increases in interest could result. Much greater coordination of economic policies is required on a worldwide basis. Economic stability cannot be achieved individually; only with a set of policies which are consistent around the world can financial and economic conditions be stabilized. (LH)

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"The Global Economy - Policy Issues and Prospects"

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Economic policies of the industrial nations are on a dangerous course, constituting a threat to growth on a worldwide basis and to financial and economic stability. The domestic orientation of policies dominates, and the impacts of domestic policies on other countries and on the world economy are being ignored. In the United States, we are pursuing a very stimulative fiscal policy, combined with a tight monetary policy. The implications have been extraordinarily high real interest rates and an overvalued dollar. High interest rates restrain growth in all countries and impose austerity on less developed countries struggling under heavy debt burdens.

The overvaluation of the dollar is destroying the United States' manufacturing industry, and it also imposes on other countries a fear of inflation that has been a major factor in economic policies around the world. Partly due to concern about the persistent rise of the dollar, other industrial countries maintained anti-inflationary policies far beyond the point at which they were appropriate. The level of unemployment has continued to rise in many countries and is near record levels throughout the industrial world. The implications of slow world growth are particularly dangerous now because of the debt burdens that all industrial countries are experiencing, but are particularly troublesome in the less developed countries of the world.

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The results of inappropriate policies throughout the industrial countries are: (1) financial strains which threaten economic stability on a worldwide basis, (2) extraordinary imbalances of trade, and (3) persistent budget imbalances. As long as these policies are in place, we will continue to have historically high real interest rates.

Economic instability is not anything new. Clearly, we have had instability in finance and economics throughout the period of accelerating world inflation of the last 20 years. Accelerating inflation which started in the middle of the 1960's led to a breakdown of the Bretton Woods arrangement of fixed exchange rates. It was the opinion of many economists that a worldwide system of fluctuating currency values would impose stability on the world financial system. The hypothesis was that if a single country was running inappropriate monetary and fiscal policies, it would be reflected by a decline in its exchange rate, isolating problems to an individual country and preventing a spillover to world economic developments. In fact, the result has been the opposite.

Misaligned exchange rates have persisted for very long periods of time, in part due to developments in the world financial system that were not anticipated and were not well understood as they were occurring. Today, currency values are determined to a greater extent by capital flows than by trade flows. Capital transactions have increased relative to trade in goods, and are now the dominant determinants of exchange rates. Consequently, there is no self-correcting mechanism that results from misalignments in currency values. Instead of a world in which trade flows correct misaligned exchange rates, we are dependent on expectations in the currency and financial markets to change in order to correct misalignments of currencies.

Inappropriate currency values have serious implications around the world. Clearly, they affect trade in goods. The U.S. manufacturing sector has been declining in

importance for a number of years, but it is losing jobs at an accelerating rate. The employment impacts are a very serious concern in the U.S., and a factor which will impact economic policies. Another serious impact of imbalances in currencies is on inflation. The rise in the dollar has helped reduce inflation in the U.S., but the current vulnerability of the dollar to a major correction creates serious concern about the course of inflation during the next few years. A final implication of misaligned exchange values is on interest rates. The inflow of foreign capital has worked to reduce interest rates in the U.S. When foreign capital flows out in response to concern about weakening of the dollar, volatile increases in interest rates could result.

What must be done to reestablish stable economic conditions is, in part, rather easy to answer. Much greater coordination of economic policies is required on a worldwide basis. Economic policies in each country must recognize the impact on others. Economic stability cannot be achieved individually; only with a set of policies which are consistent around the world can we hope to achieve stable financial and economic conditions.

The problem is more politics than economics. The inability of the U.S. government to deal with the policy problems in our country is an apt illustration and is not an encouraging sign for hoping to coordinate worldwide economic policies. It has been clear since the late 1970's that fiscal policy in the United States would have to be changed. Our tax system was outdated, providing inappropriate incentives to our economy and leading to inefficiencies in economic affairs. The stimulus provided by the high budget deficits is quite out of line with our history and inappropriate to world problems. The inability to deal with financial imbalances in the United States implies that the hope of dealing with the political problems of coordinating policies will be extremely difficult. We cannot expect change to happen soon or easily. In fact, we would be asking countries to subordinate national goals.

It has often been said that economic problems are not understandable and political problems are not solvable. I disagree with the former; I believe it is clear what changes in economic policy would move us toward greater stability. The National Association of Business Economists takes surveys of its membership on policy problems on a regular basis. For several years, over 80% of our members have agreed that fiscal policy is far too stimulative. A slightly smaller percentage has been supportive of Federal Reserve Board monetary policies in light of the fiscal problems that the monetary authorities are dealing with. When over 80% agree, that is a strong statement of understanding about what would help solve economic problems.

Political problems, however, may not be solvable. We have seen a highly partisan approach to the budget and, from my perspective as a business economist, the lack of a sense of working together to solve common problems which threaten our economic health is a stark reality. It has often been said that it probably will require a crisis before government can take the appropriate action. It is worse than that. We may have to live with a crisis for an extended period of time before consensus will come forward, even though there is an extensive knowledge concerning how we can move toward greater stability.

I have brought up the question of crisis, and let me mention a couple of problems which suggest that image. One is the world debt burdens, particularly in the less developed countries. I would simply ask, "Are we prepared for it?" The problems posed by debt burdens can be resolved. It will require coordinated government action, but the issue at this time is how to prepare for it, rather than whether it will bring down our economic system.

Many observers point to similarities with the 1930's. As in the earlier period, we are

in a transition to disinflation. Inflation increased from very low rates in the mid-60's to double-digit levels by the late 70's, before beginning its decline. The transition toward lower inflation requires major changes that affect business in a number of ways. We have trade and currency problems that remind us of the 1930's, as do the debt problems. The conclusion is not that we are headed for the kind of result that we saw in the 30's, but that we cannot afford to extend current policies for years into the future -- we're courting with dangerous results today by heading in that direction.

I would argue, however, that the potential is great for world economic growth. Looking at world economic trends, one has to be struck by the tremendous potential that exists today. There are a number of constructive changes underway that indicate high growth potential.

Within the past decade, both China and India have emerged from nations that imported substantial parts of their required food to become important exporters. Both countries have moved to provide a greater role for the marketplace in generating private incentives. When over 40% of the world's population is moving in directions which imply strong economic growth, there is basis for optimism. I would also point to technological change. The advance of new applications is proceeding at a very rapid pace, particularly in electronics and biology.

The industrial countries are in a position to lead to faster growth through more enlightened economic policies. The reduction in inflation on a worldwide basis among the industrial countries gives them the room for a change of policies. Demographic developments in the industrial countries provide the prospects for higher productivity growth and better growth of real personal income. The outlook for the financial markets has also improved. Reduced inflation implies that financial assets, particularly stocks and

bonds, will benefit relative to the tangible, inflation-oriented investments.

The question is whether we can achieve the promise for optimistic results. The direction for the prescription is clear. In the United States, we are not saving enough to fund our investments -- particularly the high level of the budget deficit. Clearly, it is essential that we reduce the deficit. Japan is saving a great deal more than it is investing. They should increase the domestic opportunities within their economy. The European economies, particularly Germany, should be going for faster growth.

To summarize my main message, better coordination of economic policies, recognizing the worldwide interdependence of our economies is essential. With the proper mix of policies, the opportunities are great.